No. 18,506

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

R. A. Riddell, District Director, Internal Revenue, Los Angeles District,

Appellant,

vs.

California Portland Cement Company,

Appellee.

On Appeal From the Judgment of the United States District Court for the Southern District of California.

REPLY BRIEF FOR THE APPELLANT.

John B. Jones, Jr.,
Acting Assistant Attorney General,

Lee A. Jackson,
Melva M. Graney,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

Francis C. Whelan,
United States Attorney,

Loyal E. Keir,
Assistant United States Attorney,
Chief, Tax Section.

808 Federal Building,
Los Angeles 12, California,

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1. The taxpayer confuses the issue by arguing, throughout the major portion of its brief, that the "addition" (*e.g.*, Br. 28, 32, 33, 44) of quartzite and iron ore to limestone in making cement is a pre-kiln process and therefore included in "mining" costs in computing the "gross income from mining" by the proportionate profits method. The "addition" of quartzite and iron ore to limestone encompasses *two* costs: (1) the cost of the quartzite and iron ore and (2) the cost, or expense, of physically adding those minerals to the limestone. We concede that the second—the act of physically adding the quartzite and iron ore to the limestone—is a pre-

kiln "process" and that the expense thereof is a "mining" cost. Our appeal relates only to the cost of the additives themselves, which covers the purchase price of the quartzite and the cost of mining the iron ore (for which the taxpayer received a separate depletion allowance).

These costs are attributable to acts consisting of purchasing the quartzite and mining iron ore. Since only the costs of "mining" *limestone* are included in "mining" costs in the proportionate profits computation and "mining" includes only such "processes" as are "applied to" *limestone* prior to the kiln-feed stage (see our main brief, pp. 15-16), the focal inquiries are (1) whether the act of purchasing quartzite is a "process" which is "applied to" *limestone* and (2) whether the act of mining iron ore is a "process" which is "applied to" *limestone.*

2. Perhaps because the answers to those focal inquiries are self-evident, the taxpayer presents no argument on the questions. Instead, although in a few portions of its brief it recognizes the limited scope of the issue (Br. 23, 40, 41 (fn.)), it makes arguments which are more generalized and, we submit, specious.

(a) The taxpayer argues (Br. 31) that the legislative materials show that Congress "chose to adopt the position that 'all processes' applied prior to the cut-off point are to be treated as 'mining', without exception." We have no particular quarrel with this as a general statement. But it is no answer to the issue when it means that the mining of limestone includes only those "processes" which are "applied to" the limestone prior to the kiln-feed stage.

(b) With reference to the statement in the Conference Committee Report that under the statute "a described process is not treated as mining where applied to a *purchased* ore or mineral" (italics supplied) (see Br. 29 and our main brief, p. 17), the taxpayer asserts, without any semblance of support, that this language, as well as the corresponding language of the statute itself, was intended to apply solely to a cement manufacturer who purchases *all or virtually all* of its *limestone.* This interpretation is plainly contrary to what Congress has said and therefore cannot be accepted. The statement in the Committee Report expresses the obvious: the depletion allowance, designed to compensate for the exhaustion of a taxpayer's mineral deposit occasioned by mining the mineral, perforce does not apply to purchased minerals.

(c) The taxpayer refers to the fact that some cement manufacturers mine a limestone called "cement rock", which contains the impurities necessary for making cement, and that, as a consequence, such cement manufacturers do not need to add materials to the limestone (additives) in making their cement. (Br. 19.) On the basis of those facts, the taxpayer asserts (Br. 32), without any attempt to support the statement, that Congress, in including all processes up to the kiln-feed stage in "mining" as to minerals used to make cement, "has merely recognized the situation of cement producers such as appellee who must look elsewhere for the desirable impurities and has placed them on a par with those using 'cement rock.' "

The explanation for the congressional adoption of the pre-kiln feed stage as the cutoff point to "mining" for minerals used to make cement is given in S. Rep.

No. 1910, 86th Cong., 2d Sess., pp. 7-10, which is printed in Appendix D to our main brief. That explanation contains no reference to placing all cement manufacturers on a par with those who mine "cement rock", a limestone of poor grade but more desirable for cement manufacture. Moreover, the taxpayer's assertion is anomalous, to say the least. To reiterate, the purpose of the depletion allowance, as the taxpayer concedes (Br. 30), is to compensate for the exhaustion of the mineral deposit occasioned by its extraction. A taxpayer is entitled to depletion only on what he himself mines, and the grade of limestone he mines is taken into account in constructively computing his depletion base (his "gross income from mining"). That a cement manufacturer may find it necessary to add other minerals to its limestone in making cement has no bearing on the exhaustion of the taxpayer's limestone deposit. The mineral additives are not depletable if purchased rather than mined, and such additives as a cement manufacturer also mines himself (here iron ore) are *separately* depletable, as Congress has said (see our main brief, p. 17).

3. The taxpayer's reliance (Br. 33-42) upon this Court's decision in *Monolith Portland Cement Co. v. United States,* 269 F. 2d 629, is misplaced. To be sure, in that case the Court held that the cost of minerals added to limestone in making cement was a part of the taxpayer's "gross income from mining" (its depletion base). But, as we interpret the Court's opinion, that holding resulted from the facts that the District Court has held that the ordinary treatment processes included in "mining" included all of the processes employed by the taxpayer in manufacturing cement (on

the ground that cement was the first marketable product) and the Government had not appealed from that holding. Thus, the Court stated (p. 633) that—

> Once this finding is made, the gross income from the sale of the cement becomes the depletion base. We find no warrant in the statute for excluding from this gross income that part representing the value of the additives. To say that the addition of other materials was not a part of the ordinary treatment process is to undercut the accepted finding that Portland cement, which requires the addition of such materials, is the first marketable product resulting from the use of ordinary treatment processes.

Two significant events have occurred since the Court's decision in that case. First, the premise of the Court's opinion (that depletion is allowable on the finished product), as urged by another taxpayer, was rejected by the Supreme Court in *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, and again in *Riddell v. Monolith Portland Cement Co.*, 371 U.S. 537, where it was held that the "mining" of limestone terminated at the crushing stage. The Supreme Court's *Cannelton* and *Monolith* decisions, and particularly *Monolith,* render this Court's first *Monolith* decision unauthoritative, since the Supreme Court's holding that the cutoff point to mining limestone is at the crushed limestone stage automatically excludes any additives from "mining". The second event was the enactment by the Congress of the elective relief legislation under which the present taxpayer, having availed itself of the election, is entitled to use the pre-kiln feed stage as the cutoff point to "mining" for its limestone. By making

the election, the taxpayer obtained a measure of relief from *Cannelton* (consistent with pre-*Cannelton* administrative practice, see Appendix D to our main brief), but that relief cannot properly be extended beyond what Congress has allowed. This brings us back to the fact that, in enacting the relief legislation, Congress imposed conditions to use of the pre-kiln feed as a cut-off point to the "mining" of limestone, *i.e.,* that only "processes" up to the kiln-feed stage which are "applied to" the limestone are included in "mining", that no depletion is allowable on purchased minerals (such as the quartzite added to the limestone by this taxpayer), and that the gross income from mining as to any additive mined by the taxpayer must be computed separately (as it was here as to iron ore). What this Court said in the first *Monolith* case has no bearing on the interpretation of a statute which had not then been enacted.

4. There is no merit in the taxpayer's attempt (Br. 42) to compare the cost of additives to expenses such as those for fuel and water consumed prior to the kiln-feed stage. The legitimate expenses of performing a process included in mining limestone are of course mining costs. But, when these expenses consist of the purchase price or cost of mining other minerals, they are *not* costs of "mining" *limestone* no matter what the other mineral may be. The taxpayer mentions (Br. 42, fn. 55) that fuel mined by a taxpayer and used by it—such as coal, oil and natural gas—is depletable, but fails to mention that it is depletable as the mineral which it is and that its cost is *not* also included in the cost of mining some other mineral and thus depleted a second time. The taxpayer also states that one court

has ruled that water is depletable (Br. 42, fn. 55) but fails to explain that it was held to be depletable as water, not as a cost of mining some other mineral.[1]

5. It is immaterial whether the taxpayer is correct in arguing (Br. 42-44) that its inclusion of the cost of additives in its costs of mining limestone is in accord with sound accounting practice. So-called "sound principles of accounting" (Br. 43), as applied to the mining of limestone, cannot control if they include, in the costs of "mining" limestone, costs which are not costs of "mining" limestone under the statutory definition of "mining".

Moreover, the taxpayer's accounting method proves nothing. The taxpayer explains it (Br. 43) simply as one under which it "accounts for all costs at the point where they actually were incurred * * *." We have no doubt of that and, consequently, that the taxpayer recorded its purchases of quartzite and its costs of mining iron ore when those costs were incurred (which may even have been in a year prior to the time those minerals were added to limestone in making cement). This does not establish that they were costs of "mining" limestone.

What the taxpayer is really asserting in this connection is not that its accounting system justifies the inclusion of the cost of quartzite and iron ore in the

[1]The taxpayer's reference in this connection is to the fact that ground water was held to be depletable in *Shurbet v. United States* (N.D. Tex.), decided January 14, 1963 (11 A.F.T.R. 2d 592). That case involved cost rather than percentage depletion, and as to ground water in the high plains of Texas which was being "depleted" in the sense that the water table was lowering because of lack of replenishment. That case is now pending on the Government's appeal to the Fifth Circuit.

cost of "mining" limestone, but rather that effect should be given to the fact that, as it states (Br. 43), it "follows its books of accounting in treating particular items of expense as having been incurred before or after the cut-off point." But what the taxpayer does for tax purposes is of no importance if it is incorrect.

The taxpayer asserts (Br. 43) that the testimony of a certified public accountant established that its method of computing its depletion allowance (by including the cost of quartzite and iron ore as a cost of "mining" limestone) is more simple and logical than excluding those costs from the mining of limestone. The simplicity of the taxpayer's method has no significance when it fails to give effect to the statutory definition of "mining".

6. The taxpayer's suggested alternative method of computing its "gross income from mining" is patently unacceptable. The proportionate profits method of computation is prescribed by the pertinent Treasury Regulations, as the taxpayer concedes, and there is no doubt about the arithmetical formula which it prescribes, as evidenced by the taxpayer's own explanation of the method at pages 20-22 of its brief. There is therefore no justification for the substitution of any other formula. Certainly the taxpayer cannot contend—and it in fact does not contend—that the Regulations are invalid. Cf. *United States v. Cannelton Sewer Pipe Co., supra*, p. 83; *Alabama By-Products Corp. v. Patterson*, 258 F. 2d 892 (C.A. 5th), certiorari denied, 358 U.S. 930.

The proportionate profits method of constructively computing the "gross income from mining" is relatively simple and certainly reasonable. It assumes that each cost produces a proportionate share of the profits and,

thus, that the "gross income from mining" is that proportion of the gross income from the sale of the finished product which the costs of "mining" bear to the total cost of producing the finished product. The formula is as follows:

$$\frac{\text{“mining” costs}}{\text{total costs of product actually sold}} \times \text{sales price of product sold} = \text{“gross income from mining”}$$

The only question in this case is whether the cost of the additives quartzite and iron ore are includible in the "mining" costs used in this formula.

Aside from the fact that the pertinent Treasury Regulations require use of the proportionate profits method in the present case,[2] the method of computation which the taxpayer suggests as an alternative is plainly not a proper method for constructively computing its "gross income from mining" limestone. The taxpayer calls it a method of allocation based on proportionate tonnage. It is in fact only partially that. It would allocate only the *sales price of bulk cement* on a proportionate basis according to the tonnage of material (limestone, quartzite, iron ore, gypsum) used in the manufacture of cement. The portion thereof attributed to "mining" would be determined (1) by subtracting the cost of all additives (those incurred both before and after the cutoff point) from the total *actual* costs to produce a *hypothetical* total cost and (2) by then determining the percentage of pre-cutoff point *actual*

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[2]The Regulations (see Appendix B to our main brief) provide that the representative market price of the mineral of like kind and grade at the cutoff point is to be used, if there is such a price, and, if not, the proportionate profits method. There is no representative market price for limestone at the pre-kiln stage (where it has been ground and mixed with quartzite and iron ore.)

mining costs to the total of *hypothetical* costs. The method of computation not only combines two unrelated factors (tonnage base as applied to the sale price of bulk cement and a cost computation without reference to tonnage) but also offsets the *actual* costs of mining against a *hypothetical* total cost of producing cement without additives.

For the reasons stated in our main brief and in this brief, we submit that the District Court erred in holding that the cost of the additives quartzite and iron ore is a "mining" cost and, accordingly, that the trial court's judgment on this issue should be reversed.

Respectfully submitted,

John B. Jones, Jr.,
Acting Assistant Attorney General,

Lee A. Jackson,
Melva M. Graney,
Attorneys,

Department of Justice,
Washington, D. C. 20530

Of Counsel:

Francis C. Whelan,
United States Attorney,

Loyal E. Keir,
Assistant United States Attorney,
Chief, Tax Section.

November, 1963.

Certificate.

I certify that, in connection with the preparation of this Brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion the foregoing brief is in full compliance with those rules.

Dated: The Sixth day of November, 1963.

Loyal E. Keir,
Assistant U. S. Attorney.